SENATE TAXATION
EXHIBIT NO. 14
DATE 3-26-07
BILL NO. SB-120

M O N T A N A CPA
Montana Society of Certified Public Accountants

March 12, 2007

To: Senate Taxation Committee

From: Shirley J. Warehime, CPA
Montana Society of Certified Public Accountants

Re: Senate Bill 120—Taxation of Real Estate Investment Trusts (REITS)

A Real Estate Investment Trust (REIT) is a corporation, trust or association that elects under provision of the Internal Revenue Code to be taxed as a REIT. To qualify, at least 75% of a company's assets and income must come from real property sources, there must be at least 100 shareholders (owners) and 90% of the entity's taxable income must be distributed annually. The REIT is permitted a deduction for dividends paid.

Section 1 of this proposed legislation provides for a credit against taxes due of 100% of the fair market value of real property contributed to the state that is accepted by the board of land commissioners. Unused credit may be carried forward for three years.

- It is unusual for the full value of a deduction/expenditure/donation to be allowed as a credit against tax. This could result in a significant reduction of revenue to the state.
- The fiscal note does not reflect this reduction, apparently it is not anticipated that anyone will take advantage of this provision.
- If this provision is directed to a single taxpayer, we do not believe this is good tax policy.

Changes to deductions/income of a REITS and its shareholders:

1. The REIT would not be allowed a deduction for dividends paid.
2. Shareholders would be permitted to exclude from gross income dividends from a REIT to the extent the income had been included in Montana taxable income of the REIT.

We see several difficulties with these provisions:

- We advocate the simplification of provisions for taxation. These provisions do not simplify taxation for the individual shareholder. They in fact add complications.
- How will the shareholder obtain the information to make the computation since this is only a state adjustment?
- Some taxpayers may not understand the need exclude the dividends from adjusted gross income and thus pay tax again on the income. Others may exclude the income from all REITS thus underreporting income.

- Since the dividends are excluded for state income tax purposes, the taxpayer's basis in the investment will need to be reduced, thus, creating a different tax basis for the same property for federal and state income taxation.
- The fiscal note does not show a reduction in revenue for the reduced income and thus tax paid by the shareholder.
- Investment by REITS in Montana real estate will be less attractive than similar investment in other states.
- Dividend distribution to shareholders will be reduced by the increased business expense of the company giving a perceived lower rate of return from the investment.

We are aware that some national chains are using REITS to avoid state income taxation of income earned in a state. While we do not know the extent of this practice in Montana, a better solution would be to disallow the dividend deduction for REITS when a single shareholder or related shareholder own more than 50% or even 25% of the shares on which dividends are paid than to disallow the deduction for all REIT organizations and creating the confusion outlined above individual Montana taxpayers.